

**INDIANA DEPARTMENT OF STATE REVENUE
REVENUE RULING ST 96-13
NOVEMBER 22, 1996**

NOTICE: Under IC 422-7-7, this document is required to be published in the Indiana register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

- (1) Whether for Indiana sales and use tax, NL is a "power subsidiary" within the meaning of IC 6-2.5-4-5.
- (2) Whether, assuming NL is not a power subsidiary and the contractor (a) purchases the construction materials incorporated into the real estate component free from sales or use taxes imposed by Indiana or any other state and (b) separately invoices NL for the cost of such construction materials, the contractor is accountable for Indiana sales and use tax only on its out of pocket costs of construction materials incorporated into the real estate component.
- (3) Whether the construction costs incurred by NL in connection with the energy generating component of the energy facility will be exempt from Indiana sales and use tax.
- (4) Whether purchase of tangible personal property, including, but not limited to, gas or other energy sources, consumed by NL in connection with the operation of the Energy Facility will be exempt from Indiana sales and use tax.
- (5) Whether tolling payments made by S Company to NL in connection with the conversion by the energy facility of steam into electric energy are exempt from Indiana sales and use tax.

STATEMENT OF FACTS

At the present, the No. 5 boiler house at S Company's Indiana facility provides steam and compressed air to S Company which is consumed solely in the direct production of tangible personal property. The source of fuel for the No. 5 boiler house is blast furnace gas produced by S Company's No. 7 blast furnace. NL is a wholly owned subsidiary of an Indiana public utility holding company. NL has commenced construction of an energy facility adjacent to the No. 5 boiler house at S Company. A portion of the blast furnace gas from the No. 7 blast furnace is currently flared into the atmosphere. The No. 5 boiler house has existing boiler capacity which is not fully utilized because there is no use for any additional steam at S Company. NL will install a steam turbine generator which will allow S Company to burn the blast furnace gas which is currently flared, produce more steam in the No. 5 boiler house and deliver this steam to NL for conversion into electricity.

NL obtained a ground lease for the land in S Company's facility upon which the energy facility will be built. The initial term of the ground lease is 30 years. However, the ground lease also provides that as the Tolling Agreement is extended, the ground lease term will be extended for the same term of years as that extension. Therefore, the total period of the ground lease will always exceed the tolling term by 15 years. However, the ground lease may be terminated at the option of NL upon the termination of the tolling agreement. The ground lease will automatically terminate upon the purchase of the energy facility by S Company. NL will pay S Company \$100 in base rent upon the ground lease for the term of the tolling agreement. Thereafter, the base rent will be fair market value. The ground lease also provides for easements which will allow NL access to the energy facility in order to construct the facility. These easements will extend for the term of the ground lease, as extended. Accordingly, NL will have access to the energy facility throughout the term of the ground lease.

NL has contracted with a contractor to construct the energy facility. NL will pay for the construction of the energy facility through its own funds and funds obtained from unrelated third parties. Pursuant to the construction contract between the contractor and NL, the contractor will bill NL separately for that portion of the energy facility which will constitute a structure and which will become part of the land next to the No. 5 boiler house (real estate component) and the remaining portion of the energy facility (energy generating component). If asked, the contractual price charged by the contractor for land improvement will reflect separate charges for the labor and material portions of the land improvement. NL will be the owner of the energy facility for federal and state income tax purposes.

The steam produced in the No. 5 boiler house will be delivered to the energy facility. The energy facility will transform S Company's steam into electrical energy, which will be delivered back to S Company for use by S Company as the power source for the direct manufacture of tangible personal property. S Company will pay NL a tolling fee based on the energy conversion amount. NL will not take legal title to the steam and will never have legal title to the electricity created by the energy facility. NL will act as an energy processor of tangible personal property (steam) owned by S Company and which (in converted form as electricity) will be used by S Company for direct consumption as a material to be consumed in the direct production of tangible personal property. In a separate letter

dated April 22, 1996, the attorney indicated that the business arrangement between NL and S Company involves the furnishing of electricity by NL to S Company for monetary payment by S Company to NL.

NL will retain ultimate control of the design of the energy facility, although S Company may request design changes. However, the ground lease also provides that any major alterations to the energy facility may only be made with S Company's consent. The agreement also provides that NL will be responsible for the operation of the facility. Under a separate operation and maintenance agreement, S Company's employees will be responsible for the daily operation of the energy facility.

The agreement does not provide an option for S Company to purchase the energy facility at the end of the term. However, S Company will have an option to acquire the facility at its market value if NL does not construct the facility in a timely manner and the tolling term fails to commence within 22 months of the scheduled completion date and NL fails to pay liquidated damages as set forth in the "tolling agreement". S Company also has an option to purchase at fair market value if NL chooses not to make a major repair which costs more than \$500,000 or which is necessary for the facility to operate at or over 90% of the original demonstrated output.

In a separate operation and maintenance agreement between NL and S Company, NL will also be entitled to direct damages not compensated by insurance if S Company destroys the facility during the term of the operating and maintenance agreement. However, the amount of these damages is limited to direct damages without regard to consequential or indirect damages.

The initial term of the "tolling agreement" is 15 years. The agreement may be extended after the initial period upon agreement of the parties and renegotiation of the tolling fee.

The "tolling agreement" also restricts S Company's ability to assign its rights under the "tolling agreement". In addition, NL cannot assign its right under the "tolling agreement" to any party except a subsidiary, or a financial institution as collateral for a loan. The "tolling agreement" also prevents a change of ownership of NL during the "tolling agreement" without the consent of S Company.

DISCUSSION -- ISSUE 1

QUESTION: For the purposes of Indiana sales and use tax, is NL a "power subsidiary" within the meaning of Indiana Code 6-2.5-4-5?

Indiana Code 6-2.5-4-5 provides:

- (a) As used in this section, a "power subsidiary" means a corporation which is owned or controlled by one (1) or more public utilities that furnish or sell electrical energy, natural or artificial gas, water, steam, or steam heat and which produces power exclusively for the use of those public utilities.
- (b) A power subsidiary or a person engaged as a public utility is a retail merchant making a retail transaction when the subsidiary or person furnishes or sells electrical energy, natural or artificial gas, water, steam, or steam heating service to a person for commercial or domestic consumption.
- (c) Notwithstanding subsection (b), a power subsidiary or a person engaged as a public utility is not a retail merchant making a retail transaction when:
 - (1) the power subsidiary or person provides, installs, constructs, services, or removes tangible personal property which is used in connection with the furnishing of the services or commodities listed in subsection (b);
 - (2) the power subsidiary or a person sells the services or commodities listed in subsection (b) to another public utility or power subsidiary described in this section or a person described in section 6 of this chapter; or
 - (3) the power subsidiary or person sells the services or commodities listed in subsection (b) to a person for use in manufacturing, mining, production, refining, oil extraction, mineral extraction, irrigation, agriculture, or horticulture.

Taxpayer argues that NL is a "power subsidiary" and entitled to an exemption from Indiana sales/use tax on the material costs of the real estate component. The term "power subsidiary" is defined in Indiana Code 6-2.5-4-5 as a corporation which is owned or controlled by one or more public utilities that furnish or sell electrical energy, natural or artificial gas, water, steam or steam heat and which produces power exclusively for the use of those public utilities.

NL is owned by a holding company of a public utility and produces electrical energy, but it does not furnish or sell the electrical energy exclusively to a public utility. NL is not a "power subsidiary". However, the analysis does not end there as the subsections (b) and (c) contain the language power subsidiary **or a person engaged as a public utility** (emphasis added). The question then is whether NL is a person engaged as a public utility. The term "person engaged as a public utility" is not defined in Indiana Sales/Use Tax Regulation. The term "utility" is defined in the Public Service Commission Act as follows:

"The term " utility" as used in this act shall mean every plant or equipment within the state used for the

[production], transmission, delivery, or furnishing of [heat], light, [water], or power either directly or indirectly to the public."

U.S. Steel Corp. v. Northern Ind. Public Service Company, Inc. and Office of the Utility Consumer Counselor, 482 N.E. 2d 501 (Ind. App. Ct. 4th Dist. 1985). NL does produce, transmit and deliver light or power; however, the question then becomes whether NL is providing the power directly or indirectly to the public.. In a similar situation, U.S. Steel proposed to erect transmission facilities to provide electrical power to its two plants located in Gary, IN and Chicago, IL The Court ruled that:

"The transmission facilities U.S. Steel proposes to erect will not furnish light or power either directly or indirectly to the public, because it will be the only consumer of the power it proposes to transmit. None will be available for public consumption. Thus, U.S. Steel's utilities under the Act are *private*, not public."

U.S. Steel Corporation v. Northern Ind. Public Service Company, 482 N.E.2d 501 (Ind.App.4th Dist. 1985). The court discussed the question of when an enterprise becomes a "public", as opposed to a private, business.

"It is an essential requirement that a business or enterprise must in some way be impressed with a public interest before it may become a public utility. Accordingly, whether the operator of a given business enterprise is a public utility depends on whether or not the service rendered by it is of a public character and of public consequence and concern, which is a question necessarily dependent on the facts of the particular case."

The construction and installation of the energy facility is not intended to furnish electrical energy to the public. The energy facility is of interest only to S Company.

RULING

The Department rules that NL is not a power subsidiary or a person engaged as public utility within the meaning of Indiana Code 6-2.5-4-5.

DISCUSSION -- ISSUE 2

QUESTION: Whether, assuming NL is not a power subsidiary and the contractor (a) purchases the construction materials incorporated into the real estate component free from Indiana sales or use taxes and (b) separately invoices NL for the cost of such construction materials, the contractor is accountable for Indiana sales tax only on its out-of-pocket costs of construction materials incorporated into the real estate component.

NL has contracted with a contractor to construct the energy facility. NL will pay for the construction of energy facility. Pursuant to the construction contract between the contractor and NL, the contractor will bill NL separately for that portion of the energy facility which constitutes a structure which will become part of the land and the remaining portion of the energy facility. If asked, the contractual price charged by the contractor for the real estate component will reflect separate charges for the labor and material portions of the real estate component. Taxpayer has presented no information as to whether the contract is a lump sum contract or a time and material contract. The fact that NL's billing from the contractor will contain a breakdown between material and labor is not relevant to the application of Indiana sales and use tax.

Indiana sales/use tax regulation 45 IAC 2.2-4-22(d) and (e) provide in relevant part:

(d) Disposition subject to the state gross retail tax. A contractor-retail merchant has the responsibility to collect the state gross retail tax and to remit such tax to the Department of Revenue whenever he disposes of any construction material in the following manner:

(1) Time and material contract. He converts the construction material into realty on land he does not own and states separately the cost for the construction materials and the cost for the labor and other charges (only the gross proceeds from the sale of the construction material are subject to tax);

(e) Disposition subject to the use tax. With respect to construction material a contractor acquired tax free, the contractor is liable for the use tax and must remit such tax (measured on the purchase price) to the Department of Revenue when he disposes of such property in the following manner:

(3) Lump sum contract. He converts the construction material into realty on land he does not own pursuant to a contract that includes all elements of cost in the total contract price.

The important fact in this question is the term "contractor". "Contractor" is defined in Indiana Sales/Use Tax Regulation 2.2-4-25 as any person engaged in converting construction material into realty. In this case, taxpayer indicates the energy facility will constitute a structure which will become part of the land.

RULING

The Department rules that the contractor is liable for Indiana Sales/Use Tax on all construction material purchased in constructing the real estate component of the energy facility. Taxpayer has not established that "contractor" is performing a time and material contract. NL has no tax liability pursuant to a lump sum; unless, NL issues an exemption certificate.

DISCUSSION -- ISSUE 3

QUESTION: Whether the construction costs incurred by NL in connection with the energy generating component of the energy facility will be exempt from Indiana sales/use tax.

Under the Tolling Agreement, the steam produced in the No. 5 boiler house will be delivered to the energy facility. The energy facility will transform S Company's steam into electrical energy which will be delivered back to S Company for use by S Company as the power source for the direct manufacture of tangible personal property. The energy generating component of the energy facility will be generating electricity (a power source which could otherwise be purchased exempt from sales tax from a public utility) for the direct use by S Company in the direct manufacture of tangible personal property.

Indiana Code 6-2.5-5-3(b) provides in relevant part:

(b) Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining or finishing of other tangible personal property.

Indiana Code 6-2.5-5-3(b) does not require that the person acquiring the machinery, tools, and equipment acquire it for his direct use in the direct manufacturing process. The statute only requires that the property be used directly in the direct manufacturing process.

Indiana Code 6-2.5-5-1(a) provides in relevant part:

(a) As used in this section, "tangible personal property" includes electrical energy, natural or artificial gas, water, steam, steam heat.

Furthermore, Indiana Sales/Use Tax Regulation, 45 IAC 2.2-5-8(l) provides an exemption from sales/use tax for energy equipment that is:

(2) used to create energy that could otherwise be purchased exempt from a public utility for use by exempt equipment is exempt.

(3) When any equipment qualifies as essential and integral to the production process and also is used in an alternative nonessential and/or nonintegral manner, the exemption shall only apply to the percentage of use of the equipment used in the exempt manner.

As cited above, 45 IAC 2.2-5-8(l) provides an exemption for energy equipment which is essential and integral to the production process. The Indiana Sales/Use Regulation, 45 IAC 2.2-5-8(l), does provide a limitation for energy equipment that qualifies as essential and integral to the production process and also is used in an alternative nonessential and/or non-integral manner, then the exemption shall only apply to the percentage of use of the equipment used in the exempt manner.

Indiana Code 6-2.5-5-1 provides that the term tangible personal property includes electrical energy. NL does not qualify for the exemption provided in Indiana Code 6-2.5-5-10 as NL is not a public utility or a power subsidiary.

RULING

The Department rules that NL is eligible for the manufacturing exemption provided for in Indiana Code 6-2.5-5-3 and may purchase tax free the material costs incurred in connection with the energy generating component of the energy facility, provided the equipment purchased meets the double direct test contained in the statute and as clarified in Indiana Sales Tax Regulation 45 IAC 2.2-5-8. NL is also advised that the limitation imposed by 45 IAC 2.2-5-8(l)(3) is applicable to this situation. If the electricity is not used 100% by S Company in direct production, then NL will be subject to Indiana sales/use tax on the material costs incurred in connection with the energy generating component, based on the percentage of electrical energy that is not used in direct production by S Company.

DISCUSSION -- ISSUE 4

QUESTION: Whether the purchase of tangible personal property, including but not limited to gas or other energy sources, which is consumed by NL in connection with the operation of the energy facility will be exempt from Indiana sales and use tax.

The Department decided in issue 3 that NL is entitled to the manufacturing exemption provided under Indiana Code 6-2.5-5-3 and 6-2.5-5-5.1 and as clarified in Indiana Sales/Use Tax Regulations 45 IAC 2.2-5-8, 45 IAC 2.2-5-10, and 45 IAC 2.2-5-12; thus, the Department need not discuss the issue again.

RULING

The Department rules that the manufacturing exemption allowed under Indiana Code 6-2.5-5-3 applies and NL may purchase tax free tangible personal property, including gas or other energy sources, which is consumed by NL in connection with the operation of the energy facility, provided the tangible personal property consumed by NL in the operation of the energy facility meets the double direct test contained in the statute and regulations previously cited. Furthermore, NL is advised that if the electrical energy is not used 100% in direct production by S Company, NL will be subject to sales/use tax on the tangible personal property based on the percentage of electrical energy not used in direct production by S Company.

DISCUSSION -- ISSUE 5

QUESTION: Whether tolling payments made by S Company to NL in connection with the conversion by the energy facility of steam into electric energy are exempt from Indiana sales and use tax.

Taxpayer argues that NL's activities are best described as the performance of nontaxable services relating to S Company's property and are not subject to sales tax. This argument is compatible with the fact that the Department has ruled that NL is not a "power subsidiary" or a "person engaged as a public utility". According to the facts presented by the taxpayer, NL will not take legal title to the steam and will never have legal title to the electricity created by the energy facility. NL is being compensated pursuant to the Tolling Agreement as an energy processor of steam owned by S Company and which (in converted form as electricity) will be used by S Company for direct consumption as a material to be consumed in the direct production of tangible personal property.

RULING

The Department rules that NL is not a retail merchant engaged in the selling of tangible personal property and is not required to collect Indiana sales tax on compensation received pursuant to the Tolling Agreement.

CAVEAT

This ruling is issued to the taxpayer requesting it on the assumption that the taxpayer's facts and circumstances, as stated herein, are correct. If the facts and circumstances given are not correct, or if they change, then the taxpayer requesting this ruling may not rely on it. However, other taxpayers with substantially identical factual situations may rely on this ruling for informational purposes in preparing returns and making tax decisions. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material respect from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that subsequent to the publication of this ruling, a change in a statute, a regulation, or case law could void the ruling. If this occurs, the ruling will not afford the taxpayer any protection.

Indiana Department of Revenue